



Bill Draft 2011-RBz-18: Expedited Rule-Making for Forced Combination

2011-2012 General Assembly

Committee: Revenue Laws Study Committee
Introduced by:
Analysis of: 2011-RBz-18

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SUMMARY: *This draft requires the Department of Revenue to adopt rules regarding its interpretation of G.S. 105-130.5A, the Secretary's authority to redetermine the State net income of a corporation properly attributable to its business carried on in the State by adjusting its net income or requiring it to file a combined return. The draft provides an expedited rule-making process for these rules.*

BACKGROUND: Under current law, a corporation files as a separate entity, meaning it must determine its State net income as if a separate return had been filed for federal income tax purposes. Separate entity filing gives corporations with subsidiaries in multiple states the ability to devise ways to shift income from a high effective tax rate state to a low effective tax rate state, often through the use of passive investment companies and inter-company transactions. To administratively address the problem of income shifting between multistate corporations, the Department of Revenue has aggressively used the tools available to it to require a corporation to file a consolidated return when the Department believes the corporation's net income attributable to this State is not accurately reflected on its separate entity filing return. This action by the Department is commonly referred to as "forced combination."

In 2011, the General Assembly repealed the statutes¹ that allowed the Secretary to redetermine the net income of a corporation if the Secretary found that a report by the corporation did not reflect its true earnings from its business carried on in this State. In its place, the General Assembly provided that the Secretary may only make this redetermination if the Secretary finds the corporation fails to accurately report its State net income through the use of transactions that lack economic substance or are not at fair market value.² The more restricted interpretation becomes effective for taxable years beginning on or after January 1, 2012.

In response to this legislative change, the Department of Revenue issued the first Corporate Tax Directive³ it has issued since 2008. The Department divided the 19-page directive into two parts. The first part concerns tax years beginning prior to January 1, 2012. This part of the directive discusses the Department's interpretation of the law as it applied to taxpayers under the G.S. 105-130.6, 105-130.15, and G.S. 105-130.16 and appears to set forth the Department's application of the law as upheld by the North Carolina Courts.⁴ The second part of the directive sets forth how the Department plans to apply the new law, effective for assessments proposed for taxable years beginning on or after January 1, 2012. Representatives on behalf of the North Carolina Chamber of Commerce, the North Carolina Retail Merchants Association, and the Council on State Taxation appeared before the Revenue Laws Study Committee on March 7, 2012, and expressed concern that the Directive issued by the Department did not provide clarity to the law, exceeded the Department's statutory authority, and did not undergo the

¹ G.S. 105-130.6, 105-130.15, and 105-130.16.

² S.L. 2011-390 created G.S. 105-130.5A.

³ [Corporate Income Tax Directives Table of Contents](#)

⁴ Wal-Mart Stores East v. Hinton, 197 N.C. App. 30 (2009); Delhaize America, Inc., Plaintiff, v. Kenneth R. Lay, 2011 NCBC 2: 2011 NCBC LEXIS 9 (2011).

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formal rule-making process.⁵ The Department of Revenue expressed concern about the length of the rule-making process.

CURRENT LAW: The tax laws in Chapter 105 of the General Statutes contain two statutes that appear to give the Department of Revenue two different pathways of interpreting the law:

- G.S. 105-264 – It provides the Secretary may interpret a law by adopting a rule *or by publishing a bulletin or directive* on the law. The Department has interpreted tax law through the issuance of bulletins⁶ or directives⁷ since at least 1955. This process does not involve public notice and comment or approval by any outside authority. Bulletins and directives may be issued immediately. A directive or bulletin is not considered a binding interpretation on the courts.
- G.S. 105-262 – It provides the Secretary may adopt rules under Chapter 150B. The Department is exempt from the notice and hearing provisions of Part 2 of Article 2A of Chapter 150B. Although the rule-making process does not provide an opportunity for public notice and hearing for rules adopted by the Department, it does provide a review of the rules by the Rules Review Commission. The Commission reviews rules to ensure they do not exceed an agency's statutory authority. A rule is considered a binding interpretation on the courts. The definition of a rule in G.S. 150B-1 specifically states that a rule does not include nonbinding interpretative statements that merely define, interpret, or explain the meaning of a statute or rule and that a rule does not include statements that set forth criteria or guidelines to be used by the staff of an agency in performing audits, investigations, or inspections.

Under current law, the Department may adopt a permanent rule and submit that rule to the Rules Review Commission. The Commission meets monthly. If the rule is submitted on or before the 20th day of the month, the Commission must review it before the last day of the following month. This process could be completed in less than two months. The Commission may extend the period for reviewing a rule up to 70 days if the Commission needs more information to be able to decide whether the rule meets the standards for review. The standards for review by the Commission are limited to the following:

- Is the rule within the authority delegated to the agency?
- Is it clear and unambiguous?
- Is it reasonably necessary to implement or interpret an act of the General Assembly or of Congress or of a regulation of a federal agency?

In 2010, the General Assembly specifically provided that the Department of Revenue would be subject to the notice and hearing provisions for purposes of any rules adopted regarding forced combinations. The provision did provide for an expedited notice and hearing schedule.⁸ The Department did not adopt any rules under this provision.

⁵ [North Carolina General Assembly - Revenue Laws > Meeting Documents > 2011-2012 Meeting Documents > March 7](#)

⁶ Bulletins present the Department of Revenue's administrative interpretation and application of tax laws. The Department has 'Corporate, Excise, and Insurance Tax Bulletins', 'Individual Income Tax Bulletins', and 'Sales and Use Tax Bulletins'. The Department typically updates the bulletins annually to reflect changes in the law or administrative interpretation. However, the Department has not updated the bulletins in the last three or four years.

⁷ Directives are issued by the Department of Revenue on an as-needed basis to interpret a tax law, explain the application of law to stated facts, or to clarify an issue on which the Department has received numerous questions. Directives are not updated to reflect changes in the law or administrative interpretation. The contents of a directive may be included in an updated bulletin.

⁸ G.S. 105-262(b). Subsequent to the legislation's adoption, the Office of Administrative Hearings notified legislative staff that the wording needed to be changed to reference an "adopted rule" as opposed to a "proposed rule." The incorrect term of art unintentionally confused the processes intended by the General Assembly. However, this subsection is no longer valid because the statute it references has been repealed.

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BILL ANALYSIS: The Revenue Laws Study Committee heard several presentations this interim on the issue of forced combination, the directives the Department of Revenue issued concerning the newly enacted law regarding forced combination, and the issues surrounding rule-making as it applies to the Department of Revenue. This proposal seeks to balance the following three goals:

- The need for taxpayer certainty about the tax laws – expediency.
- The need for an outside determination as to whether the Department of Revenue has exceeded its statutory authority in its interpretation of the law.
- The opportunity for public notice and comment on the Department's interpretation of the law.

The proposal requires the Secretary to adopt rules providing guidance to taxpayers on its administration of GS 105-130.5A, the newly enacted law regarding the Secretary's ability to redetermine a corporation's State net taxable income by adjustment or by forced combination. To expedite the rulemaking process, the proposal does the following:

- Provides the rulemaking procedure will be the quicker timetable allowed for temporary rulemaking:
 - The Department must submit its proposed rule to OAH and interested parties.
 - OAH must publish the rule on the Internet within five days of the submission.
 - The Department must hold a public hearing on the proposed rule within five days of publication.
 - The Department must accept public comment for at least 15 days.
 - The Department may adopt the rule 30 days from the time the proposed rule is submitted.
 - If the Department does not receive any written objection to the rule, the rule may be delivered to the Codifier of Rules and entered into the Code. If the Department receives written objections to the rule, then the Rules Review Commission must review the rule within 15 days. The Commission may not extend the period of time for review.
- Changes the fiscal note requirement to allow Revenue to prepare its own fiscal note.⁹ It will not need to submit the fiscal note to OSBM. The fiscal note must be submitted with the proposed rule to the Codifier of Rules and posted on the Internet.
- Exempts the Department from the delayed effective date provisions that apply whenever the Commission receives 10 or more objections to a rule requesting review by the legislature.

Rules adopted by the Department for G.S. 105-130.5A would apply to taxable years beginning on or after January 1, 2012; that is the effective of G.S. 105-130.5A.

EFFECTIVE DATE: The proposal would become effective when it becomes law.

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⁹ A fiscal note must be prepared if the rule has a substantial economic impact. Prior to 2011, the term 'substantial economic impact' meant a cumulative impact of \$3,000,000. In 2011, this amount was reduced to \$500,000.